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Nos. 89-1502, 89-1503

IN THE

Supreme Court of the United States

OCTOBER TERM, 1989

No. 89-1502

AMERICAN STOCK EXCHANGE, INC., ET AL.,
Petitioners,

v.

CHICAGO MERCANTILE EXCHANGE, ET AL.,
Respondents.

No. 89-1503

PHILADELPHIA STOCK EXCHANGE, INC.,
Petitioner,

v.

CHICAGO MERCANTILE EXCHANGE, ET AL.,
Respondents.

ON PETITIONS FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

JOINT REPLY OF PETITIONERS TO BRIEFS IN OPPOSITION

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The petitioners in No. 89-1502, American Stock Exchange, Inc., Chicago Board Options Exchange, Incorporated and The Options Clearing Corporation, and the petitioner in No. 89-1503, Philadelphia Stock Exchange, Inc., submit this joint reply to the briefs in opposition filed by the Solicitor General "for the federal respondent" ("S.G. Br.") and by respondents Chicago Mercantile Exchange and Board of Trade of the City of Chicago ("CME/CBT Br.").[1]

ARGUMENT

A. The brief in opposition filed by the Solicitor General shows that the issues presented by this case loom large in the administration of two federal regulatory schemes. The brief states that the proper resolution of these issues "is important to regulators, to the financial markets subject to their jurisdiction, and to the interpretation of the two statutory schemes in question." (S.G. Br. 7.) It notes that, in the view of the SEC[2]—the agency of the United States which is the federal respondent in this case[3]—the holding of the court of appeals "is wrong and its underlying analysis creates a climate of uncertainty about the proper boundaries between [the SEC's] jurisdiction and that of the CFTC" and that this "will harm financial innovation, capital markets, and investors." (*Id.* 7–8.) The brief further notes that the SEC shares the petitioners' concern that the confusion and uncertainty created by the court of appeals' decision "will inhibit the development, approval, and marketing of new products in the Nation's financial sector" and that this "will impede the Nation's financial markets in international competition." (*Id.* 26.) The brief makes clear that the issues involved are sufficiently important to receive "high-level attention under the aegis of the President's Working Group on Financial Markets," as well as the attention of a number of Congressional committees, and it notes that the Adminis-

[1] The lists included at p. ii of the petitions for a writ of certiorari in Nos. 89-1502 and 89-1503 pursuant to Rule 29.1 of the Rules of this Court remain currently accurate.

[2] The abbreviations used in this reply brief are the same as those used in the petition in No. 89-1502.

[3] The brief is captioned "Brief for the Federal Respondent in Opposition," even though the SEC is the only federal respondent, the brief is not signed by any of the SEC's attorneys, and it is plain on the face of the brief that the SEC believes that certiorari should be granted. (S.G. Br. 8.)

tration believes that jurisdictional squabbles of the kind involved in this case " 'can strangle innovation. New products are not merely stifled; they quickly move to overseas markets.' " (*Id.* 29, n.36, quoting the statement of Robert R. Glauber, Under Secretary of the Treasury for Finance, before the Senate Agriculture Committee on May 8, 1990.) Finally, it states in summation that "the proper interpretation of the CFTC's jurisdiction is an important question that this Court has not had an occasion to address." (S.G. Br. 30.)

The Administration and the SEC also have stressed the importance of the issues presented here in their testimony before Congress. For example, in his May 8, 1990 statement to the Senate Agriculture Committee, Under Secretary Glauber, expressing the Administration's views, noted that the result of the court's current interpretation "has been protracted litigation over what constitutes a 'future'; an inability to trade in the U.S. markets most suited to the product; and the shifting of business to more hospitable overseas markets. This is precisely what happened to Index Participation Certificates, which now trade in Toronto rather than the United States." (Statement of Robert R. Glauber, Under Secretary of the Treasury for Finance, before the U.S. Senate Committee on Agriculture, Nutrition, and Forestry, May 8, 1990, at 10.) Similarly, in recent Congressional testimony, Chairman Breeden testified that as a result of the court of appeals' decision "it is most unlikely that any U.S. securities exchange will trade, or any corporate issuer will issue, any new security that may even be argued to include any element of a futures contract" and that the decision "could do incalculable damage to the U.S. securities markets." (Testimony of Richard C. Breeden, Chairman of the SEC, before the Subcommittee on Securities of the Committee on Banking, Housing, and Urban Affairs, March 29, 1990, at 7.) It is thus plain that the questions presented are viewed by the Administration and the SEC as being of great importance to the regulation, competitiveness and development of the Nation's markets.[4] The Solicitor General's brief does not basically disagree with these conclusions.

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[4] On June 5, 1990, the Department of the Treasury transmitted the Administration's legislative proposal to Congress. The proposal con-

(Footnote continued on following page)

B. Under the statutory scheme governing the regulatory authority of the SEC and the CFTC, the SEC (and not the CFTC) has been given jurisdiction "to regulate the trading of any put, call, straddle, option or privilege on any . . . group or index of securities (including any interest therein or based on the value thereof)," and the CFTC (and not the SEC) has been given jurisdiction with respect to "transactions involving . . . contracts of sale (or options on such contracts) for future delivery of a group or index of securities (or any interest therein or based upon the value thereof)." Section 9(g) of the Exchange Act, 15 U.S.C. § 78i(g); Sections 2(a)(1)(B)(i) and (ii) of the CEA, 7 U.S.C. §§ 2a(i) and (ii). Further, if a transaction involves a "security" but not a futures contract, then it is subject to the regulatory jurisdiction of the SEC under the securities laws. The word "security" is a defined term in the Exchange Act and the other federal securities laws, and it has also been the subject of considerable interpretation by this Court. *See, e.g., Reves v. Ernst & Young,* 110 S.Ct. 945, 948–52 (1990); *Marine Bank v. Weaver,* 455 U.S. 551, 555–56 (1982); *Tcherepnin v. Knight,* 389 U.S. 332, 335–40 (1967). On the other hand, the other terms used as the basis for allocating regulatory jurisdiction—"option," "privilege," and "contracts of sale for future delivery"—have no statutory definition, and their meanings have never been decided or settled by this Court.

1. The definition of "contracts of sale for future delivery" (or "futures contracts") has proved to be an elusive one. The court of appeals decision and the Solicitor General's brief in this case are breaking new ground when they reject bilateralism as an essential element of a futures contract. The CFTC's brief before the court of appeals refers to bilateral obligations as an

[4] *continued*

tains a provision that is intended by the Administration to overrule the court of appeals' decision in this case because the "result of this decision . . . has been to impede the development of innovative financial instruments that may have some aspect of futurity." (*See* Letter from Jeanne S. Archibald, Acting General Counsel of the Department of the Treasury, to Dan Quayle, June 5, 1990, enclosing Section-by-Section Analysis of proposed legislation, at 10.)

"essential element of a futures contract." (CFTC App. Br. 10; S.G. Br. 18.) Similarly, when the Solicitor General petitioned for a writ for certiorari on behalf of the SEC in *SEC v. Board of Trade of the City of Chicago, et al.*, No. 82-526, he stated:

> Unlike an option, a futures contract is an executory sales contract, involving a promise to deliver and a promise to take delivery and make payment at some time after the contract is formed.

(S.G. Pet. in No. 82-526, at 18, n.18.) This definition—which includes bilateral obligations of both buyer and seller—conforms with those supplied by commentators. *See, e.g.*, Gilberg, *Regulation of New Financial Instruments Under the Federal Securities and Commodities Laws*, 39 Vand. L. Rev. 1599, 1603 (1986); 1 P. Johnson & T. Hazen, *Commodities Regulation*, § 103, p. 10 (2d ed. 1989). Thus, both the court of appeals' decision and Solicitor General's brief reject earlier views as to how to define a futures contract. They both give great deference to the conclusions of the CFTC (but not the reasoning) that IPs are futures contracts (App. 22-24; S.G. Br. 17-18), but they provide little guidance as to why one instrument should be deemed to be a "futures contract" and another not.

2. The case of *CFTC v. Co Petro Marketing Group, Inc.*, 680 F.2d 573 (9th Cir. 1982), was cited by the court of appeals as authority for its finding that bilateralism was not an essential element of a futures contract (App. 21), and this citation is supported by the briefs in opposition. (S.G. Br. 15; CME/CBT Br. 11-12.)[5] However, the contracts in *Co Petro* were in fact bilateral, as both parties were obligated to perform at a specified future date even though the buyer's financial obligation was limited by a liquidated damages clause. *Co Petro*, 680 F.2d at 576. It is therefore inaccurate to speak of *Co Petro* as authority for the elimination of bilateralism as an essential element of a futures contract.

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[5] The *Co Petro* decision, which respondent futures exchanges note is the *only* other appellate case addressing these issues (CME/CBT Br. 12), was rendered by a divided court. The dissenting judge stated: "There is an indication that Congress intended . . . to regulate the sale of 'futures' *as that term is used in the trading markets of the nation*." *Co Petro*, 680 F.2d at 587 (Smith, J., dissenting; emphasis supplied).

Clearly, the CFTC did not think of *Co Petro* as such authority when it filed its brief with the court of appeals.

3. In concluding that IPs are futures contracts, the Solicitor General's brief places significant emphasis on the conclusions that a function of the futures markets is to permit hedging and that one function of IPs is to serve as a hedge. (S.G. Br. 12-13.) There are two deficiencies with this argument. First, the SEC never found that IPs would function as hedging instruments.[6] Instead, it found that IPs had the economic characteristics of other securities and that IPs would provide retail investors with a means "to invest in 'the market.' "[7] (App. 47-53, 69.) Accordingly, the Solicitor General is supplying a finding that the SEC did not make.[8] Second, as the Solicitor General recognizes (S.G. Br. 13), securities options can and are used as hedging instruments. In addition, other types of securities—*e.g.*, warrants and convertible stocks and bonds—can also be used as hedging instruments. Thus, even if IPs could be used secondarily for hedging purposes, this would not serve as a principled basis for treating them as futures contracts for jurisdictional purposes.

4. The Solicitor General's reading of the legislative history is flawed. (S.G. Br. 20-23.) The brief quotes a Congressional statement that SEC jurisdiction would be preserved "in those areas traditionally regulated by it" (S.G. Br. 21) and concludes that only traditional securities, such as stocks, remain free from the jurisdictional inroads of the CFTC. Apart from the fact that this conclusion ignores other relevant statements by Congress,[9] it reads what Congress said too narrowly. IPs were designed to be marketed, traded on national securities exchanges and cleared

[6] *See* petition in No. 89-1502, at 14, n.16.

[7] That was essentially the reason why the Investment Company Institute argued that IPs are investment company shares. (App. 37.)

[8] The Solicitor General reached his conclusion based on a belief by CBOE that a feature of its form of IP would assist shorts who wished to hedge. (S.G. Br. 12-13; App. 30.) However, this feature was not included in the IPs traded on AMEX and PHLX and therefore cannot properly be used as a general basis for allocating jurisdiction.

[9] For example, the petition in No. 89-1502 noted that Congress had described the exclusive jurisdiction clause as applying to the trading of

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like options and other securities, and it was certainly within the SEC's "traditional area of regulation" to regulate the trading of those instruments in the same manner that it regulated other securities. (Pet. in No. 89-1502, at 5-6.) That the SEC was acting in its traditional area of regulation was emphasized by the Chairman of the SEC, in a letter to Congress explaining why the SEC did not agree with a compromise suggested by the CFTC to consider cross-registration of securities brokers under CFTC rules if IPs were traded on futures exchanges. Among other things, the Chairman said that:

> the Commission believes that the securities regulatory system, which has a primary emphasis on retail investor protection, is ideally suited for IPs. In approving IPs, the Commission concluded that IPs might be of substantial interest, not only to institutional investors, but also to retail investors as a lower cost means of obtaining the economic equivalent of an investment in a portfolio of stock. In part because of the expected retail interest in the product, the Commission concluded that the regulatory protections for retail investors in place for the securities markets should be applied to IPs.

(Letter from David S. Ruder, Chairman of the SEC, to Senators Patrick Leahy and Richard Lugar, May 22, 1989, at 2–3; footnotes omitted.) On the other hand, IPs were not designed to be marketed, traded or cleared in the manner traditionally applicable to futures contracts, and petitioners believe that IPs could not be successfully marketed and traded in such manner.[10]

The Solicitor General misunderstands Congress' use of the word "traditionally." Congress said "*areas* traditionally regulated by it," but the Solicitor General shifts this to "*instruments* it

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[9] *continued*

"futures on organized contract markets," and that it had said that, with that exception, it did not wish to infringe on the jurisdiction of the SEC. (Pet. 16.)

[10] *See* Statement of Wayne P. Luthringshausen, Chairman of the Board of OCC, before the Subcommittee on Telecommunications and Finance of the House of Representatives Committee on Energy and Commerce, May 24, 1990, at 9–10; Testimony of James R. Jones, Chairman, AMEX, before the House Subcommittee on Telecommunications and Finance, May 24, 1990, at 9–10.

traditionally regulated." (S.G. Br. 21–23; emphasis supplied.) There is nothing in the legislative history to suggest that Congress intended to freeze the SEC's jurisdiction to the group of instruments that were regulated by it prior to 1974 or that the SEC was not to be the federal regulator of new forms of investment. On the other hand, there is nothing in the court of appeals decision or in the CFTC's release to suggest that "traditional" securities having an element of "futurity" may not be held to be subject to the CFTC's exclusive jurisdiction.[11] As is shown by a recent release relating to hybrid instruments, the CFTC believes that its jurisdiction could extend to certain bonds, preferred stocks and equities. *Regulation of Hybrid Instruments*, 54 Fed. Reg. 30684, 30684–85 (1989).

5. As discussed in the petition in No. 89-1503, the court of appeals determined that the CIP possessed "futurity" despite the fact that the CIP gave an investor the right to realize the value of his investment on a *daily* basis. (Pet. 9–11). The court noted that the daily cash-out provided for the payment of 99.5% of the value of the underlying index, rather than 100%, and reserved decision on an instrument providing for 100% cash-out. (App. 27–28.) The Solicitor General argues that the court's reservation on an instrument that differs to only a "minute" degree evidences the "limited nature of the court's holding." (S.G. Br. 27–28, n. 34.) However, neither the court nor the Solicitor General offers a reasoned basis for distinguishing between two fundamentally identical instruments that differ only by 0.5% of economic value. Instead of illustrating that the holding was limited, the court of appeals' treatment of the daily cash-out illustrates the confusion its decision engenders.

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[11] The Solicitor General's brief implies that the TIPs being traded on the Toronto Stock Exchange may not be futures contracts because they are backed by units of trust that hold the securities in the index. (S.G. Br. 26, n.33.) It is hard to see how this would make a difference under the Solicitor General's "key characteristic" test (S.G. Br. 14–15), since the short is required to deliver at a future date whether or not the underlying securities are held in trust. Thus, rather than clarifying matters, the Solicitor General's test has extended the reach of the definition of "futures contract" to embrace such traditional investment company securities as units of trust.

6. Petitioners in No. 89-1502 argued that one of the important jurisdictional provisions adopted by Congress in 1982—Section 9(g) of the Exchange Act, 15 U.S.C. §78i(g), which vested the SEC with jurisdiction to regulate the trading of any "privilege on any . . . group or index of securities (including any interest therein or based on the value thereof)"—was not considered by the court of appeals even though the court had noted that "IPs convey privileges based on the value of an index." (Pet. 22–24.) The Solicitor General does not comment on the merits of this argument; instead he contends, citing *SEC v. Chenery Corp.*, 318 U.S. 80, 92–95 (1943), that review of the question is not warranted because the SEC did not rely in its order on Section 9(g).[12] (S.G. Br. 24–25.)

Chenery involved a "determination of policy or judgment which the agency alone is authorized to make and which it has not made" and not a determination of jurisdiction. 318 U.S. at 88. When it next took up the Chenery matter, the Court said:

> a reviewing court, in dealing with a determination or judgment which an administrative agency alone is authorized to make, must judge the propriety of such action solely by grounds invoked by the agency. If those grounds are inadequate or improper, the court is powerless to affirm the administrative action by substituting what it considers to be a more adequate or proper basis. To do so would propel the court into the domain which Congress has set aside exclusively for the administrative agency.

SEC v. Chenery Corp., 332 U.S. 194, 196 (1947). Certainly, a determination as to whether an agency has jurisdiction is not a determination that "an administrative agency alone is authorized to make." The *Chenery* principle does not apply to determinations by an agency of its own jurisdiction, and an agency does not lose jurisdiction conferred by statute by failing to assert all of the bases for exercising it.[13]

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[12] However, as the petition in No. 89-1502 notes (Pet. 23, n.32), the analysis in the SEC's order is not inconsistent with reliance on Section 9(g).

[13] In this case, the CFTC stated that it had jurisdiction for reasons that were not accepted by the court of appeals. The court of appeals and the

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Further, even if the *Chenery* doctrine were applicable to agency determinations of jurisdiction, the court of appeals should have remanded the proceeding to the SEC for its determination as to the applicability of Section 9(g). *See, e.g., FTC v. Sperry and Hutchinson Co.*, 455 U.S. 233, 249–50 (1972) (modified court of appeals' reversal of agency order to require a remand to the agency for its determination whether to apply the alternate rationale offered in support of its order). It would therefore be appropriate, if the Court did not wish to decide this issue on the merits at this stage, for the Court to grant certiorari and to modify the court of appeals reversal so as to require a remand to the SEC on this issue.[14]

7. The respondent futures exchanges argue that IPs are not options or privileges. (CME/CBT Br. 14–16.) In doing so, they rely on a 1926 case and a 1936 remark of a Senator to provide a definition of a word used by Congress in a 1982 enactment designed to make it certain that the SEC would have jurisdiction to regulate transactions in "any" option or privilege. The futures exchanges thus want to have it both ways: they want "futures contract" to be defined in a way that has no relationship to any traditional use of the term and to be expandable as the need arises,[15] and, at the same time, they want to limit the definitions of "option" and "privilege," as used to fix the jurisdiction of the SEC, to 50-year old usages in the commodity markets. Clearly, Congress intended a more evenhanded treatment. The question as to how these jurisdictional words should be defined remains an open one that, we believe, is important for this Court to examine.

[13] *continued*
Solicitor General are prepared to accept the CFTC's bottom-line conclusion, but not its reasoning, notwithstanding *Chenery*. There is no reason to apply a different standard to the bottom-line conclusion of the SEC.

[14] The Solicitor General says that the SEC is not foreclosed from considering the application of Section 9(g) to IPs. (S.G. Br. 25.) However, in the absence of a remand, it is difficult to see how it would be possible for the SEC to open up this issue.

[15] The futures exchanges argue that the court of appeals found IPs to be futures contracts because "(1) an IP's value depended upon the on-

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C. The respondents argue that this Court should leave it to Congress to correct any mistaken holding by the court of appeals. (S.G. Br. 28–29; CME/CBT Br. 18–19.) However, the pendency or possibility of a legislative solution should not deter the Court from granting certiorari. In the absence of legislative action, the agencies and the public must look to the courts for final resolution of conflicting statutory interpretations of existing laws. If the Congress should enact legislation overruling the decision of the court of appeals, the Court will be able to vacate the judgment as moot. If, on the other hand, Congress does not act, it remains important for this Court to settle the important jurisdictional questions involved.

CONCLUSION

The petitions for a writ of certiorari in Nos. 89-1502 and 89-1503 should be granted.

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[15] *continued*
going market assessment of the value that the stock index would have on a 'prescribed' or 'defined' future date . . . and (2) IP's do not convey an ownership interest in the stock in the index." (CME/CBT Br. 11.) This not only departs from the reasons advanced by the Solicitor General (S.G. Br. 14–15), but it also ignores that the value of virtually all securities (other than common stocks, which, like IPs, have a perpetual existence) depends on assessments of value of the underlying assets or obligations at a prescribed future date, and that Congress adopted Section 9(g) and amended Sections 3(a)(10) and 28(a) of the Exchange Act to allow for securities which are based on the value of an underlying index and which do not convey an ownership interest in the securities in the index. *See* H.R. Rep. No. 626, 97th Cong., 2d Sess., pt. 1 at 9, *reprinted in* 1982 U.S. Code Cong. & Admin. News 2780, 2787.

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